Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Ducheny and Machado	Analyst:	Nicole Kwon	Bill Number:	SB 1008
Related Bills:	See Legislative History	Telephone:	845-7800	Amended Date:	January 19, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT:	Enterprise Zone, Manufacturing Enhancement Area, Targeted Tax Area & LAMBRA Hiring Credit, NOL Deduction & Business Expense Deduction

SUMMARY

This bill would make various changes and reforms to existing law regarding Enterprise Zones, Manufacturing Enhancement Areas, Targeted Tax Areas, and Local Agency Military Base Recovery Areas.

This analysis addresses only those provisions of the bill affecting the Franchise Tax Board (FTB).

SUMMARY OF AMENDMENTS

The January 19, 2006, amendments struck the previous provisions relating to a study about adult education funding and would make revisions to the following areas of the Economic Development Areas (EDAs):

A. Designation of Enterprise Zones.
B. Designation of Targeted Employment Areas.
C. Hiring Credit.
D. Net Interest Deduction.
E. Business Expense Deduction.
F. Net Operating Loss.

Each item is discussed separately below.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to enact meaningful reforms to the EDA programs to ensure that the state maximizes its investment in the programs and targets benefits to economically challenged areas and individuals.

EFFECTIVE/OPERATIVE DATE

If enacted in 2006, this bill would be effective January 1, 2007. The operative dates of these changes vary and will be addressed separately for each provision.

Board Position:			Department Director	Date
________ S	________ NA	________ NP	Selvi Stanislaus	3/20/06
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POSITION

Pending.

A. Designation of Enterprise Zones (EZs)

ANALYSIS

STATE LAW

Under the Government Code, existing state law allows the governing body of a city or county to apply for designation as an EZ. Using specified criteria, the Department of Housing and Community Development (DHCD) designates EZs from the applications received from the governing bodies. EZs are designated for 15 years.

An area may qualify to apply to become an EZ in two ways. First, by meeting one of the following criteria: (1) qualifying for the Urban Development Action Grants (now defunct), (2) the area within the proposed EZ has experienced plant closures within the past two years affecting more than 100 workers, (3) meets criterion of economic distress under the Urban Development Action Grants (now defunct), or (4) the area has a history of gang activity. Second, by meeting at least two of the following criteria: (1) the census tract within the proposed zone have an unemployment rate not less than 3 percentage points above the statewide average for the most recent calendar year as determined by the Employment Development Department (EDD), (2) the county of the proposed zone has more than 70% of the children enrolled in public school participating in the federal free lunch program, or (3) the median household income for a family of four within the census tracts of the proposed zone does not exceed 80% of the statewide median income for the most recently available calendar year.

Currently, all of the 42 authorized EZs have been designated.

An EZ designated before 1990 may have its designation period extended to 20 years if it meets both of the following requirements:

- The EZ received a superior or passing audit grade from the responsible agency.
- An updated economic development plan was submitted to the responsible agency that justified the additional five-year designation period.

This extension does not apply to EZs designated after 1990. Once designated, DHCD may audit EZ programs and determine a result of superior, pass, or fail, and may dedesignate failing programs. Any business located in a dedesignated zone that has elected to avail itself of any state tax incentive for any taxable year prior to dedesignation may continue to avail itself of those tax incentives for a period equal to the remaining life of the dedesignated EZ, provided the business otherwise is still eligible for those incentives.

THIS BILL

This bill would do the following:

- Extend the designation period for EZs if they meet specified criteria. As a result, EZs, including those EZs that were created after 1990 with a designation of only 15 years, would be eligible to have the designation period extended for two additional five-year periods for a total designation period of 25 years.
- Allow DHCD to approve time extensions of EZs with revised boundaries to ensure that these EZs may be extended with boundaries that conform to the new criteria.
- Allow changes to the definition of an EZ's "eligible area" by allowing for noncontiguous boundaries.

The changes made by the bill with respect to the designation of EZs would be operative on and after January 1, 2007.

LEGISLATIVE HISTORY

AB 1766 (Dymally, 2005/2006) is identical to this bill except for the provision authorizing DHCD to assess and collect a fee of up to $10 for the administration of each application it issues for the vouchering certificates for EDAs. AB 1766 is currently on its third reading on the Senate floor.

SB 6 (Ducheny, 2005/2006) would expand the time for which EZs could be designated as an EZ to 20 years if certain criteria are met. SB 6 is currently in the Senate Revenue & Taxation Committee.

AB 708 (Correa, 2003/2004), SB 172 (Ducheny, 2003/2004), SB 1179 (Ducheny, 2003/2004), and AB 1846 (Correa, 2001/2002) would have expanded the time for which EZs could be designated as an EZ to 20 years. AB 708 and SB 172 failed to pass out of the first house by January 31 of the second year of the session. SB 1179 was held in Senate Appropriations. AB 1846 failed to pass out of the Senate Revenue & Taxation Committee.

AB 516 (Matthews, 2003/2004) would have expanded EZs eligible for the 20-year designation period to include an EZ located in a rural area after 1990. This bill failed to pass out of the first house by January 31 of the second year of the session.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Based on the discussion below, the total revenue loss from this bill is as follows:

Estimated Revenue Impact of AB 1766 Effective Date 1/1/2007 Fiscal Year (In Millions)			
	2006-07	**2007-08**	**2008-09**
Sunset Extension	-8	-34	-27

Note: This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

<u>Revenue Discussion</u>

The largest revenue impact from this bill would be generated by the extension of sunset dates for EZs. This impact will not begin, however, until the first set of currently scheduled sunset dates in October 2006. Tax return data indicates that the tax effect attributable to EZs set to expire in 2006 is approximately $70 million annually, before adjustments. This potential revenue loss was reduced to account for three factors: First, EZ employers will be allowed to continue claiming hiring credits for employees who were hired prior to an EZ's expiration until those credits run out five years after the employee was hired. Second, taxpayers will be allowed to use excess credits carried over from previous years. Third, new EZs will likely be designated to replace the expired EZs (these may include redesignation of some or all of the expired EZs). The estimate assumes that the new designations will begin approximately 18 months after EZs expire.

This bill would also allow changes to the definition of an EZ's "eligible area" by allowing for noncontiguous boundaries. This estimate assumes that, on average, changes in the shape of EZs will not affect the amount of credit claimed in each EZ. Depending on the specific changes made to EZ boundaries could result in additional changes to the revenue impact of EZs.

<u>**B. Designation of Targeted Employment Areas (TEAs)**</u>

<u>STATE LAW</u>

Under the Government Code, a TEA is designed to encourage businesses in an EZ to hire eligible residents of certain geographic areas within a city, county, or city and county. A TEA may be, but is not required to be, the same as all or part of an EZ. EZs may draw TEAs to contain census tracts where 51% or more of the individuals are low or moderate income. TEAs are drawn using census data at the time of the EZ's formation. A resident of a TEA can be certified as a qualified employee for purposes of the EZ hiring credit. See discussion below.

BACKGROUND

Currently, census tracts are used to determine TEAs. Census tracts usually contain between 2,500 and 8,000 people, whereas census block groups, the smallest unit of analysis where the Census Bureau measures household income, are statistical subdivisions of census tracts, including between 600 and 3,000 people.

THIS BILL

This bill requires all EZs to redraw TEAs within 180 days of new census data becoming available.

This bill raises the residents' income threshold from 51% for a census track to 61% for a census block group for EZs designated or extended after January 1, 2007.

This bill requires EZs designated on or after January 1, 2007, to use census block groups when determining TEAs for EZ. An existing TEA satisfying the census track threshold will be required to satisfy the census block group threshold upon the first updating of census data after January 1, 2007.

This provision would be operative as of January 1, 2007.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

FISCAL IMPACT

This portion of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

This portion of the bill is not anticipated to impact significantly the amount of revenue.

C. Hiring Credit

STATE LAW

Under the Government Code, state law provides for several types of Economic Development Areas (EDAs): EZs, Manufacturing Enhancement Areas (MEAs), Targeted Tax Areas (TTAs), and Local Agency Military Base Recovery Areas (LAMBRAs).

The Revenue and Taxation Code provides an income and franchise tax hiring credit for taxpayers operating in an EDA.

A business located in an EDA is eligible for a hiring credit equal to a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an EDA and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the EDA and at least 50% must be performed inside the EDA.

The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (under special circumstances for the Long Beach EZ, the maximum is 202% of the minimum wage). The amount of the credit must be reduced by any other federal or state jobs tax credits, and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit. Certain criteria regarding whom may be a qualified employee and certain limitations differ between the various EDAs.

Taxpayers operating in an EDA are allowed the hiring credit for employing "qualified employees." "Qualified employees" for EDAs are defined by reference to various state and federal public assistance programs. The categories of individuals considered qualified employees for the various EDAs are substantially similar but not identical. A taxpayer located in an EDA is allowed a credit of up to 50% of wages paid to "qualified employees." The taxpayer is required to obtain a voucher certificate for each of its "qualified employees." The voucher certificates are issued by EDD or the local (within the same EDA as the workplace of the employee) agency familiar with the public assistance statutes.

Existing state law allows local governments administering an EZ to issue vouchering certificates for the hiring credit. DHCD is authorized to develop regulations that govern the issuance of vouchering certificates by these local governments.

For MEAs, LAMBRAs, and TTA, the California Employment Development Department and the local entities that administer the Job Training Partnership Act and Greater Avenues of Independence Act (GAIN) have the authority to issue the voucher certificates. The voucher certificate indicates that the employee is qualified for or is receiving any of the specified forms of public assistance and thus is a "qualified employee" for purposes of the hiring credit.

Taxpayers that claim the hiring credit are required to retain a copy of the voucher certificate for each of its "qualified employees." Upon the request of FTB, the taxpayer is required to provide the voucher certificate for purposes of verifying the hiring credit claimed by the taxpayer.

<u>THIS BILL</u>

This bill would do the following:

- Revise the requirements for qualified employees to require certain employees to be enrolled and documented in the California Job Training Automation System by an authorized federal Workforce Investment Act (WIA) representative.
- Revise the requirements for the category of qualified employees to require receipt of benefits under California Work Opportunity and Responsibility to Kids program.
- Define "economically disadvantaged individual" and "dislocated worker" as an individual who meets the definition of those terms under the WIA.
- Require applications for voucher certificates to be submitted to the certifying agency within 24 months of the commencement date of employment with the taxpayer.
- Clarify the requirement for employers to obtain a voucher certificate from the local agency in the area in which the employee is employed.
- Revise the definition of veterans to an individual who served in the active military, naval, or air service and who was discharged or released from that service other than dishonorable or any veteran who was discharged or released in the last 48 months from active military, naval, or air service.
- Revise the definition of qualified employees to ex-felons, rather than all ex-offenders.

IMPLEMENTATION CONSIDERATION

This bill would raise the following implementation consideration.

The bill states that for EZs, the provisions shall apply to "taxable years beginning on or after January 1, 2007, and to vouchers for hiring credits issued after that date." This is inconsistent with the date used for MEAs, LAMBRAS, and TTA that references "vouchers issued after January 1, 2007." To avoid the confusion and improve clarity, the author may want to consider using the same transaction-related operative dates for the amendments made to the hiring credits of all EDAs.

TECHNICAL CONSIDERATION

On page 16, line 25 and page 26, line 2, "or" should be eliminated and a comma added.

LEGISLATIVE HISTORY

AB 1766 (Dymally, 2005/2006) is identical to this bill except for the provision authorizing DHCD to assess and collect a fee of up to $10 for the administration of each application it issues for the vouchering certificates for EDAs. AB 1766 is currently on its third reading on the Senate floor.

SB 1097 (Senate Budget Comm., Stat. 2004, Ch. 225) authorized local governments to issue vouchering certificates and authorized DHCD to issue emergency regulations to allow local governments to assess a fee for the administration of the EZ hiring credit.

OTHER STATES' INFORMATION

Florida allows businesses located in an EZ a credit based on wages paid to new employees. Other wage-based credits are offered to businesses that are located in high crime areas or in rural areas. Job tax credits are earned by employers, if hired employees reside in the designated EZ or a rural county. Up to 45% of an employee's wages may be claimed as a job tax credit.

New York allows a wage credit to a business that hires a full time employee (either one in targeted group or not) for a newly created job in an Empire Zone.

Illinois, Massachusetts, Michigan, and *Minnesota* do not offer a wage credit to small business employers.

Texas allows EZs to be designated for any census block group with a poverty rate of 20% or more. Currently there are 169 EZs with no limitation on the number of zones in existence at any one time. Businesses operating in an EZ may claim a hiring credit of up to $1.25 million per year, if 25% of their jobs are reserved for low-income individuals.

Virginia currently designated 52 EZs, on a competitive basis, for 20-year durations.

Most of these states offer assistance such as financial, marketing, licensing, finding employees, tax seminars, and training to small businesses.

FISCAL IMPACT

This portion of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This portion of the bill is not anticipated to significantly impact revenue.

Revenue Discussion

This bill clarifies the definition of a qualified employee for EZs, qualified disadvantaged individual or qualified displaced employee for LAMBRAs, and qualified disadvantaged individual for MEAs for the purpose of claiming the various EDA hiring credits. Based on current interpretations of this definition by FTB, EDD and DHCD, this estimate assumes that the definition is the same as current law. In the event that the department's interpretation is rejected in the tax controversy process, this bill would prevent substantial losses of revenue in the form of credits for employees that may be qualified under alternative interpretations of these definitions.

D. Net Interest Deduction

ANALYSIS

FEDERAL/STATE LAW

A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an EZ. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the EZ, and the lender may not have equity or other ownership interest in the EZ trade or business. This incentive is not available for LAMBRAs, MEAs, or TTA.

THIS BILL

This bill would limit the deduction to interest received on loans made to businesses that are physically located within the EZ and do not have physical locations both inside and outside the EZ.

This bill requires lenders to verify and document that the loan proceeds are spent within the EZ to qualify for the deduction.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation consideration.

The author's office might want to revise the language on both personal and corporate income tax law sections to state clearly how the loan proceeds should be spent within the EZ to qualify for the deduction. For example, to qualify for the deduction, the loan proceeds are spent for expenditures for assets used in or services received in an EZ.

OTHER STATES' INFORMATION

Florida, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a deduction comparable to the deduction allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

Illinois has a Growing Economy Tax Credit Act that provides tax credits to businesses creating new jobs and making capital investments. A taxpayer that has entered into an agreement under the Growing Economy Tax Credit Act is allowed a credit against the tax. The Department of Revenue and the Illinois Business Investment Committee determine the amount and duration of the credit, which must not exceed 10 taxable years. Under Illinois law, a subtraction is allowed to financial organizations for interest from a loan or loans to a borrower, to the extent the loan is secured by property that is eligible for the EZ investment credit.

FISCAL IMPACT

This portion of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

This portion of the bill would have insignificant impact on the amount of revenue associated with existing and future EZs.

LEGAL IMPACT

This bill would provide incentives for EZs in California.

The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. This case is now pending with the U.S. Supreme Court. The Court will issue its decision on this case by the end of June, 2006. Although the outcome of this decision and its affects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

Pending federal legislation titled, "Economic Development Act of 2005," S. 1066 and H. R. 2471, would authorize state tax incentives for economic development purposes that may otherwise be subject to constitutional challenge as discriminatory.

E. Business Expense Deduction

ANALYSIS

STATE LAW

A business located in an EDA (except an MEA) may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the EDA. The deduction is allowed in the taxable year in which the taxpayer places the qualified property in service. For LAMBRA businesses, the amount of the deduction is added back to the taxpayer's income if, at the close of the second year, the taxpayer does not have a net increase of one or more jobs (defined as 2,000 paid hours per employee per year). The property's basis must be reduced by the amount of the deduction. For EZs, LAMBRAs, and TTA, the maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

…	The applicable amount is:
Taxable year of designation	$100,000
1st taxable year thereafter	100,000
2nd taxable year thereafter	75,000
3rd taxable year thereafter	75,000
Each taxable year thereafter	50,000

THIS BILL

This bill would increase the business expense deduction from 40% to 60%.

This bill would expand the cap on deductions to $100,000 for any year in the EZ.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

TECHNICAL CONSIDERATION

On page 107, line 6, "$1000,000" should be changed to "$100,000".

OTHER STATES' INFORMATION

Illinois conforms to federal provisions of allowing taxpayers to treat the cost of certain tangible property that is acquired by purchase for use in the active conduct of a trade or business as an expense not chargeable to a capital account. The limitation on the deductible cost of the property is increased by either the lesser of $35,000 or the cost of the property placed in service during the taxable year.

FISCAL IMPACT

This portion of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1766 Effective Date 1/1/2007 Fiscal Year (In Millions)			
	2006-07	**2007-08**	**2008-09**
Expensing	(minor)	-1	(minor)

Note: This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Revenue loss would result from the revised limits on the expense deductions by businesses. The bill would triple the limit on qualified expenses per taxpayer. It is estimated that this would result in approximately $15 million annually in new qualified expenses. This would result in a revenue loss of about $1 million in tax year 2006. Thereafter, the revenue loss diminishes because current expensing will be offset by reduced depreciation of assets that were expensed in earlier years.

F. Net Operating Loss (NOL)

ANALYSIS

STATE LAW

A business located in an EDA may carry over 100% of the EDA net operating losses (NOLs) to deduct against EDA income in future years. The NOL carryover is determined by computing the business loss that results from business activity in the EDA. The carryover period for NOLs is 15 years.

For businesses operating inside and outside an EDA, the amount of credit or NOLdeduction that may be claimed is limited by the amount of tax on income attributable to the EDA. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor). This income is further apportioned to the EDA using a two-factor formula based on the property and payroll of the business.

THIS BILL

This bill would make the rules for NOLs in the various EDAs (EZs, LAMBRAs, and TTA) uniform. It would accomplish uniformity by making the following changes:

- Extend the carryover period for deducting an EDA NOL from 15 to 17 years.
- Eliminate the rules applied to determine the amount of an NOL attributable to an EDA, and
- Eliminate application of the apportionment formula for determining the income against which the EDA NOL may be deducted.

IMPLEMENTATION CONSIDERATION

This bill would raise the following implementation consideration.

This bill would state that for purposes of computing the NOL amount (subject to carryover), the loss is limited to the loss attributed to the taxpayer's business activity in the EDA. The bill would also eliminate the definition of "loss attributed to the taxpayer's business activity in the economic development area." This definition is needed to determine the limitation.

TECHNICAL CONSIDERATIONS

Changes to subdivision lettering were not updated in cross-reference language. For example, the subdivision (c) on page 64, line 16 needs to be replaced with subdivision (d).

LEGISLATIVE HISTORY

AB 511 (Alquist, Stats. 2000, Ch. 107) incrementally increased the general NOL from 50% to 65% and increased the carryover period from five to ten years.

AB 2065 (Oropeza, Stats. 2002, Ch. 488) suspended the deduction for NOLs, increased the carryover percentage to 100% of the loss for tax years beginning on or after January 1, 2004, and extended withholding on real property to nonresidents.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida income tax law, with respect to corporations, provides a 20-year carryover period but no carryback for general NOL, and otherwise conforms to federal NOL laws. *Florida* has no personal income tax.

Illinois income tax allows net loss carryover or carryback in the amount of any net loss for a taxable year that may be used to offset income in another tax year. For tax years ending on or after December 31, 2003, the general NOL carryover period is 12 years and no carry back is allowed.

Massachusetts income tax law does not allow general NOL treatment for personal income taxpayers, but corporations are allowed a 100% NOL that applies to the first five years of the entity's existence.

Michigan income tax law conforms to federal NOL laws, including the allowance of general NOL carrybacks for corporations. However, *Michigan's* personal income tax law does not allow NOL carrybacks.

Minnesota personal income tax law conforms to federal NOL laws, while corporate taxpayers determine NOLs pursuant to federal law but have no NOL carrybacks and only a 15-year carryover period.

FISCAL IMPACT

This portion of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on the discussion below, the revenue loss from this bill is as follows:

Estimated Revenue Impact of AB 1766
Effective Date 1/1/2007
Fiscal Year
(In Millions)

	2006-07	2007-08	2008-09
NOLs	-1	-5	-4

Note: This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This provision of the bill would have an immediate impact on revenue due to liberalization of the use of NOLs in EDAs. Current law for NOL expensing allows 40% of up to $50,000 ($50,000 x 40%= $20,000). This bill would allow 60% of up to $100,000 ($100,000 x 60%=$60,000). This bill's provision of $60,000 is triple the amount of $20,000 under current law.

Average NOL usage 2000 through 2002, prior to suspension in 2003, was $22.9 million. The impact of this bill would be to triple the current law followed by deducting the original amount that would have occurred anyway [($22.9 million x 3 =$68.7 million)-$22.9 million=$45.8 million)]. An average tax rate of 8% was applied for the final impact ($45.8 million x 8%=$3.7 million), rounded to the nearest whole million to $4 million. The results in the table above have been adjusted to reflect fiscal year estimates.

POLICY CONSIDERATION

Eliminating the current law provision that allows the taxpayer's California source business income attributable to EDAs to be applied only to business income generated from EDAs will create a question as to how NOL losses that have already been incurred and subject to carryover provisions will be used in the future years.

LEGISLATIVE STAFF CONTACT

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